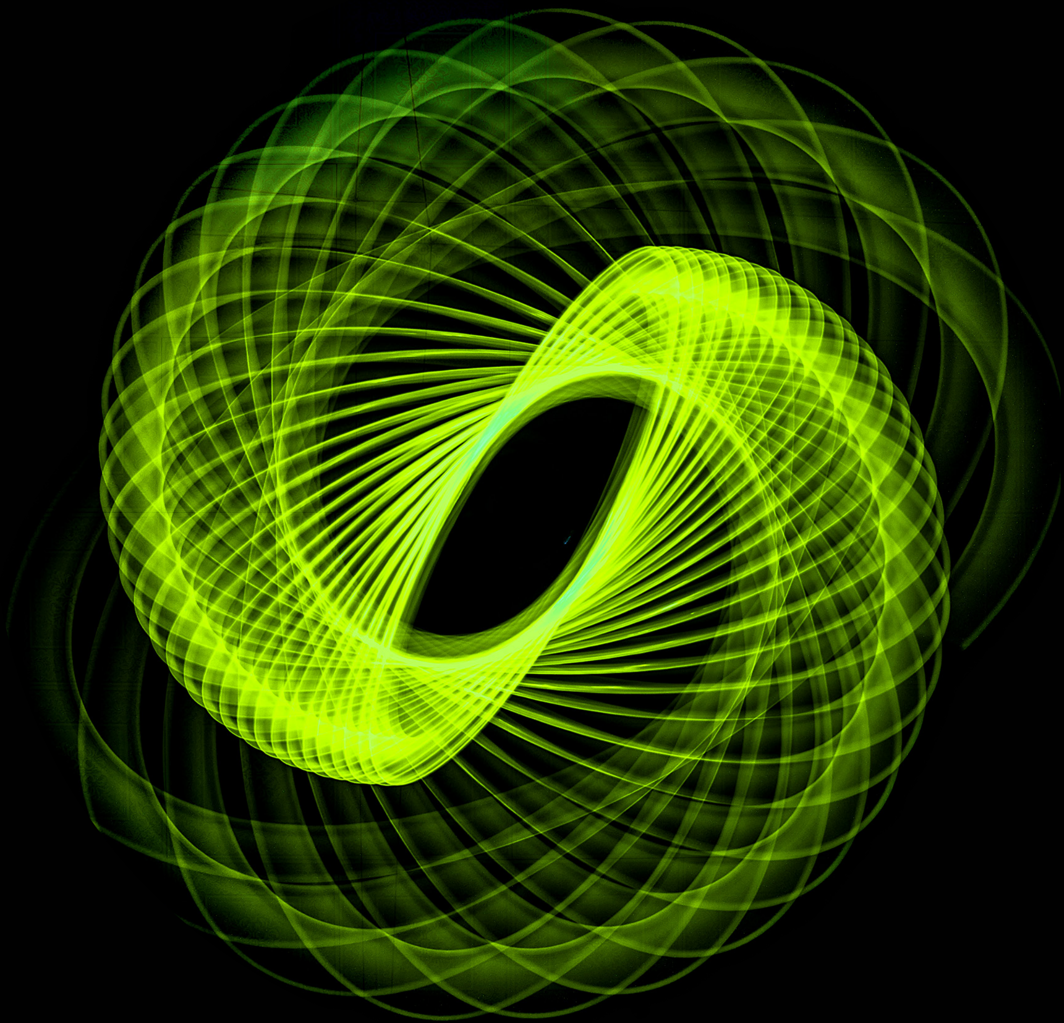

What is the impact of COVID-19 on your unlisted asset valuations?

Financial reporting considerations for directors, trustees and executives

COVID-19 and unlisted asset valuations - financial reporting considerations

The challenges in valuing unlisted assets in the current environment have been well publicised. Uncertainty in relation to the inputs to those valuations is greater than at any point in the memory of most, including during the Global Financial Crisis (GFC).

Many asset managers (including superannuation funds) and their institutional service providers have had to move swiftly to evaluate and revalue unlisted assets and set unit prices that are fair. The year end for many Australian asset managers is 30 June, and financial reporting requirements will add an additional lens to unlisted asset valuation.

Under Australian Accounting Standards a wide range of assets are accounted for at 'fair value' as defined by AASB 13: *Fair Value Measurement*.

Fair value is based on the asset being used for its highest and best use to maximise its value. When applying AASB 13 three valuation techniques need to be considered:

1. **The market approach –** using prices generated by market transactions
2. **The cost approach** – factoring in current replacement cost
3. **The income approach** – most commonly the present value of future cashflows from the asset.

Due to the current COVID-19 crisis, the significant reduction in market transactions and uncertainty in relation to future cashflows mean that challenges in valuing unlisted assets will be heightened, and governance processes around valuations will be critical. This will be exacerbated by downstream and upstream liquidity considerations in the volatile market over the coming months.

In this paper, we highlight some of the governance questions directors and senior executives should ask when estimating asset values for this reporting period.

Real estate

Real estate investments held either directly or in investment vehicles are generally less susceptible to short-term market volatility compared with stocks or certain other financial instruments. However, property values can fluctuate significantly in the short-term, particularly when the economy experiences an unexpected shock as it currently is.

Tenant behaviour has changed significantly over a very short period of time, with tenants facing significant operational and commercial pressures. In Australia, the SME Commercial Leasing Code of Conduct was issued to provide guiding principles to frame good faith lease renegotiations. Despite the guidance provided there will still be significant commercial and practical challenges to be worked through.

The impact of the COVID-19 pandemic on various property classes differs significantly.

- *Retail* - the issues already facing the retail sector and the substitution of physical stores with online fulfilment are being compounded.
- *Office* - trends including working remotely and a period of prolonged physical distancing are leading tenants to re-evaluate their long-term office space needs (potentially lower numbers of people in office but more space needed) and will require innovative strategies from landlords to generate new revenue streams.
- *Hospitality* - real estate investments in the hospitality, gaming, and transportation industries, such as casinos, parking garages, etc., will see significant short-term and potentially long-term effects on their underlying real estate forecasts and valuations.
- *Hotel and leisure assets* - as international travel is likely to be one of the last restrictions to be lifted, this will impact the demand for hotel accommodation and other leisure assets.

Importantly, not all impacts from the pandemic necessarily involve evaluating downside risk. Sub-sectors including industrial assets such as warehouses, logistics, etc., may see increased medium and long-term demand, as businesses adjust their operations to a post-COVID-19 world.

Questions to consider

- ✔ *Impacted assets:* The impacts of COVID-19 potentially differ significantly across property class - retail, office, industrial, hotel etc. How has COVID-19 impacted your properties' cashflows and the sectors your tenants operate in? Could your property valuations be significantly impacted?
- ✔ *Policies & processes:* Are your valuation policies and processes still relevant? Do they need to be modified?
- ✔ *Valuation policy:* Is a formal independent valuation required under your property valuation policy as at the reporting date for all properties? Is a rotational approach to independent valuations in place? If rotational, what governance processes are in place to give the board comfort that valuation risk for properties not independently valued at balance date will be effectively managed?
- ✔ *Risk based valuation selection:* If risk based, are criteria applied to determine which properties require full, independent valuations? Is this approach still appropriate? Is it appropriate to increase the sample of properties subject to full, independent valuations?

- *Governance:* Have governance mechanisms such as additional valuation focused audit committee meetings or board valuation sub committees been established or expanded at management and/ or board level to facilitate sufficient and robust challenge of valuation methodologies and assumptions? Is the interaction between the audit and investment committees clearly defined? Is appropriate documentation, including minutes and/or valuation position memorandums, produced to document the decisions made and evidence them? What other data needs to be considered by management and the board?

- *Internal models:* Where internal models are applied, are there sufficient and appropriate controls to validate the continued suitability of the model and its mathematical integrity? Are any changes to the model adequately tested? Are the key components of the model including methodology, assumptions, limitations and results of any validations appropriately documented?

- *Valuation methodology:* Is the valuation methodology used still appropriate? Can a cap rate be reasonably established for an asset? Is it appropriate to consider alternative methods given the absence of transactions and uncertainty over market prices between a willing buyer and a willing seller?

- *Data:* Does the source data for the valuation remain relevant and reliable? Does this include data both generated internally and sourced externally from market data vendors? Does the data in the valuation reflect current contractual terms, including changes to lease terms and conditions such as abatements and extensions? How has the integrity of the data been maintained and checked through the valuation process? Is there a need for further benchmarking against external sources given the current volatility and uncertainty? Is relying on a single valuer adequate?

- *Timing assumptions:* Do valuation processes appropriately consider and document uncertainties such as the timing of any 'return to normal', including views on property usage in a post COVID-19 world, to provide balanced views to drive valuations?

- *Scenario analysis:* Has sensitivity and scenario analysis been performed to allow management and board assessment of new possible ranges of valuation?

- *Macro inputs:* Are 'macro' inputs such as inflation and risk free rates still relevant and appropriate?

- *Cross checks:* Where appropriate, have the assumptions in the valuations been cross checked against budgets, forecasts or assumptions used in both the going concern assessment and forecast covenant compliance? Are there significant risks highlighted from a cashflow and / or covenant compliance perspective? If so, does this require a review of the valuation assumptions if the timeframes used in the valuation models are no longer appropriate?

- *Third party managers:* For investments into listed or unlisted property funds, are management and the board comfortable that the underlying asset manager has undertaken sufficient work to provide confidence in the valuation of underlying properties? Aligned to this, are your oversight, monitoring and reporting procedures with these service providers sufficiently robust for this environment?

- *Caveats:* Do any caveats on any independent valuations mean it may not be possible to rely on a valuation for financial reporting purposes by the date the directors sign the financial statements, or are additional disclosures about the independent valuations required?

- *Post balance date movements:* If market volatility continues through to the point of signing the financial statements, for the purposes of the subsequent events note has management and/or the board considered what steps may be necessary in order to obtain comfort over property valuations?

- *Disclosure:* Does financial reporting disclosure need to be amended to provide users with enough information to understand valuation uncertainty? Have financial statement disclosures adequately considered valuation risks and how these are managed, including key assumptions, changes to past assumptions, sources of uncertainty in the valuation and an understanding of the range of possible outcomes for the valuation?

Infrastructure

Since the GFC, the value of infrastructure assets has progressively been appreciating as a result of declining interest rates and an abundance of capital available to be deployed by superannuation/pension and sovereign funds.

While the COVID-19 pandemic does not necessarily adversely affect these dynamics (in fact, it increases the likelihood that risk free rates will remain low for longer), its impact on infrastructure users' behaviour is creating uncertainty over the future financial performance of this asset class.

GDP-linked, transport and uncontracted energy assets are the most likely to be adversely affected while Public- Private Partnerships (PPP) and contracted, regulated energy assets appear to be relatively sheltered. In contrast, data centres and telecom towers may receive a boost over the medium term.

This dynamic is evident from the recent share trading performance of infrastructure-like assets. Does the short to medium term impact on demand for such assets justify the decrease in value driven by the general market downturn?

Questions to consider

- *Impacted assets:* The impacts of COVID-19 potentially differ significantly across asset classes including transportation, utilities, communication, renewable energy, social infrastructure and PPP assets. How has COVID-19 impacted your assets, the assets' cashflows and/or the sectors your investments operate in? Accordingly, could valuations be significantly impacted?

- *Policies and processes:* Are the valuation policies and processes still relevant and appropriate? Do they need to be modified?

- *Valuation policy:* Is a formal independent valuation required under policy as at balance date for all assets or is a rotational approach to independent valuations in place? If rotational, what governance processes are in place to give the board comfort that valuation risk is being identified and managed?

- *Risk based valuation selection:* If risk based criteria are applied to determine which infrastructure assets require full, independent valuations, is this approach still appropriate? Is it appropriate to increase the sample of assets or positions subject to full, independent valuations?

- *Governance:* Have governance mechanisms, such as additional valuation focused audit committee meetings or board valuation sub committees, been established or expanded at management and/or board level to facilitate sufficient and robust challenge of valuation methodologies and assumptions? Is the interaction between audit committee and investment committee clearly defined? Is appropriate documentation including minutes and/or valuation position memorandums produced to document the decisions made, and are the evidence and other data considered by committee members?

- *Market approach:* Are there any assets for which the manager is relying on a historical valuation or a historical transaction to support the current valuation? What analysis has been undertaken to support this? Is this valuation approach still appropriate or would an alternative approach, such as the income approach, be more appropriate?

- *Methodology:* Is the valuation methodology used still appropriate? Are there sufficient valuation cross checks? Is it appropriate to consider alternative methods given the absence of transactions and uncertainty over market prices between a willing buyer and a willing seller? Which point of the valuation range has been selected (i.e. low-mid-high) and is this still appropriate?

- *Uncertainty:* What is the approach to factoring uncertainty into the valuation? There is significantly heightened uncertainty around the economy and impacts on businesses models, market transactions and other factors that drive assumptions in valuation models. Do valuation processes appropriately consider and document uncertainties such as the timing of any 'return to normal? Are the views on asset usage, e.g. passenger demand and the flow on impacts on all income streams in an airport asset, in a post COVID-19 world sufficiently balanced to drive valuations?

- *Macro inputs:* Are 'macro' inputs such as inflation and risk free rates still relevant and appropriate? Have they been appropriately factored from an indirect perspective, for example, into forecast revenue and cost growth? What external support or analysis is there for these inputs?

- *Scenario analysis:* Has sensitivity and scenario analysis been performed to allow management and board assessment of new possible ranges of valuation? Do these sensitivities and scenarios take account of debt level implications?

- *Third party managers:* For investments into listed or unlisted infrastructure funds, are management and the board comfortable that the underlying asset manager has done sufficient work to provide confidence in the valuation of the underlying assets? Aligned to this, are your oversight, monitoring and reporting procedures with these service providers sufficiently robust for this environment? Have you considered the implication of liquidity or withdrawal requests?

- *Caveats:* Do any caveats on any valuations mean it may not be possible to rely on a valuation for financial reporting purposes by the date the directors sign the financial statements?

- *Post balance date movements:* If market volatility continues through to the point of signing the financial statements, for the purposes of the subsequent events note, has management and/or the board considered what steps may be necessary in order to obtain comfort over infrastructure valuations?

- *Disclosure:* Does financial reporting disclosure need to be amended to provide users with enough information to understand valuation uncertainty? Have financial statement disclosures adequately considered valuation risks and how these are managed, key assumptions, changes to past assumptions, sources of uncertainty in the valuation and an understanding of the range of possible outcomes for the valuation?

Private market equity and debt investments

The overall market decline resulting from COVID-19 signals that many private market equity and debt investments could be overvalued depending on the impacts on the underlying company.

In evaluating the nature and extent of the impact of COVID-19 on a business, its income forecasts and valuation assumptions, directors and executives should consider a variety of issues including store or facility closures, loss of customers or customer traffic, impact on distributors, supply chain interruptions, production delays or limitations, the impact on human capital, banking caveats, regulatory changes and the risk of losing significant contracts.

As the magnitude and the duration of the above dynamics are highly uncertain, the revaluation of investments based on increased risk premiums, whether equity or debt funding, may be a reasonable temporary solution. Directors and executives should also consider a range of alternative scenarios in order to assess the potential impact of COVID-19 on their investments.

Questions to consider

- *Impacted assets:* The impacts of COVID-19 can differ significantly for all companies. How has COVID-19 impacted operations and cashflows of your portfolio companies? Accordingly, could valuations be significantly impacted?

- *Policies and processes:* Are the valuation policies and processes still relevant and appropriate? Do they need to be modified?

- *Governance:* Have governance mechanisms, including additional valuation-focused audit committee meetings or board valuation sub committees, been established or expanded at the management and/or board level to facilitate sufficient and robust challenge of valuation methodologies and assumptions? Is the interaction between the audit and investment committees clearly defined? Is appropriate documentation including minutes and/or valuation position memorandums produced to document the decisions made and the evidence and other data considered by management and the board?

- *Valuation policy:* Where investments into portfolio company equity and debt instruments are held directly by you, is a formal independent valuation required under policy as at balance date? Or is a rotational approach to independent valuations in place? If rotational, what governance processes are in place to give the board comfort that valuation risk is being identified and managed?

- *Investments into PE vehicles:* Where investments into portfolio companies or private equity funds (PE funds) are managed through an independent asset manager, is a formal independent valuation required under that manager's policy as at balance date? Or is a rotational approach to independent valuations in place? Aligned to this, are your oversight, monitoring and reporting procedures with these service providers sufficiently robust for this environment? In respect of investments in funds, have you considered the implication of liquidity or withdrawal requests?

- *Timing of valuation:* Where underlying audited financial statements of portfolio companies, or PE funds, are used as part of the valuation processes and those entities have a different reporting date to your own, how is the intervening period being managed?

- *Methodology:* Is the valuation methodology used by yourself or your independent asset manager still appropriate? Are there sufficient valuation cross checks? Is it appropriate to consider alternative methods given the absence of transactions and uncertainty over market prices between a willing buyer and a willing seller?

- *Third party managers:* What steps have you gone through to discuss, and where appropriate challenge, investment team processes for valuations of portfolio companies and PE funds? In particular what methodologies and assumptions are used to recognise and adjust for any material valuation uncertainty?

- *Uncertainty:* There is significantly heightened uncertainty around the economy and its impact on business models, market transactions and other factors that drive assumptions in valuation models. Do valuations of the underlying portfolio companies and PE funds appropriately consider and document these uncertainties and provide balanced views to drive appropriate valuations?

- *Scenario analysis:* Have sensitivity and scenario analyses been conducted to assess the new possible valuation ranges of the portfolio companies and PE funds?

- *Caveats:* Do any caveats on any valuations of the underlying portfolio companies mean it may not be possible to rely on a valuation for financial reporting purposes by the date your directors sign the financial statements?

- *Post balance date movements:* If market volatility continues through to the point of signing the financial statements, for the purposes of the subsequent events note, has management and/or the board considered what steps may be necessary in order to obtain comfort over portfolio companies and PE funds?

- *Disclosure:* Does financial reporting disclosure need to be amended to provide users with enough information to understand valuation uncertainty? Have financial statement disclosures adequately considered valuation risks and how these are managed, key assumptions, changes to past assumptions, sources of uncertainty in the valuation and an understanding of the range of possible outcomes for the valuation?

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